

Wednesday, April 08, 2009

Mary F. Rupp  
Secretary of the Board  
The National Credit Union Administration 1775 Duke Street  
Alexandria, Virginia. 22314-3428

RE: Comments on Advanced Notice of Proposed Rulemaking, Part 704

Dear Ms. Rupp:

The Management and Board of the First citizens' Federal Credit Union welcomes the opportunity to comment on the NCUA's Notice of Proposed Rulemaking for NCUA Regulation, 12 CFR, Part 704. In general, our comments are focused upon the needs of the Natural Person Credit Unions (NPCU) and the role of the Corporate Credit Unions in supporting their primary mission of financing consumers and small businesses. If the service to the natural person system is subordinated to the largely superfluous structure of the corporate credit unions, then the NCUA would seemingly be making the same mistakes as the banking regulators who seem predominantly focused on a "Wall Street" view of banking.

The perils that currently plague the "Corporates" are driven by a mentality that something can be had for nothing, or in suspending disbelief in the hope that modern financial science can be used to eliminate all forms of credit and default risk. We at First Citizens' are of the belief that this is a very odd mindset to have arrived at when the very industry that is served has excelled for so long at finance "in the small" and prospered in a modest way by using sound banking principle to serve family and small business needs, cost effectively and safely.

We prefer to believe that the managers and the NCUA did not succumb to the moral hazard of the broader financial services industry, but remain very skeptical given the period of time it took to finally uncover the investment and judgment errors that were identified very early on in other sectors. Our view that interposing a two-tier structure of Corporate Credit Unions with broader powers than those of the industry it serves is a most dangerous sort of paternalism, and possibly arrogance, and has resulted in a much higher concentration of risk. It too, may well have resulted in a large number of very small credit unions that cannot survive, and will not survive in the post apocalyptic world we will find ourselves in following the immediate crisis.

This must be the subject of a follow up Advanced Notice of Proposed Rulemaking by NCUA, and should address the pressing need for a review of the mutual credit union charter, access to capital and corporate structures that would facilitate an efficient consolidation process of natural person credit unions; something akin to the Mutual Holding Company framework that is afforded community banks. Failing to acknowledge past errors in not insisting on strong financial institutions governed by strong management teams will inevitably result in the ultimate demise of the Credit Union Industry.

On the Corporate Credit Union system, it is certainly the case that there are too many of them to be successful and it has become clear that some considerable consolidation is necessary for them to succeed. Whether the surplus of Corporate Credit Unions and possible pressure on competitive returns is due to their market area being defined nationally is an open but irrelevant issue at this stage. On a practical level, the NCUA needs to consolidate the system immediately if for no other reason than to aggregate Corporate-System capital to absorb losses. On a broader level the NCUA needs to ask an even deeper

question, should the system exist at all? There are options for all of the services offered by the system including payment system operations.

With the massive financial exposure the corporate system has experienced, and which ultimately will fall on the natural person system, it needs to be asked whether these services can be offered more cost effectively elsewhere. We would call for a full examination of form and function and ask the NCUA to conduct a competitive cost analysis of the system and compare these results to other market or governmentally sponsored operations that now compete with the Corporate System. If it is found that they are indeed less efficient in comparison to other providers of similar services then they should be unwound and the remaining capital distributed to the industry. In today's competitive marketplace inefficient operations at the Corporate-level will ultimately spell the demise of the institutions the system serves.

It is the perception of many within the Credit Union Industry that the structure of the Corporate Credit Union system is an insiders' game and rife with self and insider dealing. This is very evident from the Governance structure of the Corporate Credit Unions. There is absolutely no outsider representation on the Boards of these organizations, and all are linked through vertical and cross-board linkages that are generally considered an anathema to good, open governance. Certainly the interlocking nature of the US Central and second tier corporate boards should long ago have raised issues of board conflict of interest. This situation perpetuates the perception that the upper tiers of the Credit Union system is an "old boy" club of insiders seeking a sort of insulation of the credit union industry from the pressures of the broader financial services industry. That this is presumably done to ensure the purity and independence of the Credit Union mission is folly, and disingenuous at best. Most would have thought by now that the principles of good corporate governance would have permeated the credit union industry given the massive effect that Sarbanes-Oxley has had on the broader corporate world in general.

So, in the final analysis ANPR questions about eliminating the second tier, or wholesale corporate tier, isolating payment systems risk from other risks, disassembling what are appropriate services and products for the system, restructuring corporate boards, tightening or eliminating certain investment authorities that the system would be in better stead we would say, it is a bit late for all of that! These are all obvious questions that should have been asked sooner rather than later, and been a natural byproduct of the supervision of these entities a long time ago. By ignoring conflicts, insider control, competitive inconsistencies and prudent financial operations, we are inevitably at the point of determining what the endgame is for the Corporate Credit Union system.

In the following several sections we address the specific questions raised by the NCUA to provide detailed responses.

### **The Role of the Corporates in the Credit Union System**

The first section of the ANPR raises the essential question that needs to be addressed by the NCUA. Do we need the Corporate Credit Unions? It might also be framed as "can we afford the Corporate Credit Union System"

- The NCUA needs to recognize the fundamental realities of the current financial services market place, and that harsh reality is that Credit Unions are not an independent and autonomous network that can continue to operate in its own protected space.
- The Corporate Credit Union system fancied itself as the guardian of the Credit Union System, but the invasion of market forces increasingly made this an impossible situation.
  - The two tier system, never made any sense, since any of the "retail corporates" could and do perform many of the payments functions served by U.S. Central just as easily, absent access to the CLF.

- The large number of Retail corporates placed undue margin pressure on all of the corporates and led to unwise investment decisions, impairment and insolvency.
- Small credit unions without the sophistication to contract for market-priced services on the investment and transactions front, extracted a rent from the corporates that ultimately led to their demise, and the survival of way too many small credit unions.
- Deflecting industry capital to support the corporates will unnecessarily impair the Natural Person system, as surely as protection of the Natural Person Credit Unions impaired the Corporates.
  - The focus of the NCUA should be upon the Natural Person Network and not on preserving the Corporate Network, at least as its mission is currently construed.
  - That focus should be on Charter reform to expand investment powers for Credit Unions, so they can compete on a level basis with other financial intermediaries.
- There is not enough room in the US financial system for 7,900 credit unions encompassing some \$ 800 billion in footings.
- The myth that the CU industry is very well capitalized needs exploration, due to the fact that it is really an over populated system with capital sequestered in small pockets and insufficient on an absolute basis to forestall meaningful invasions by credit or investment events on the scale of today's financial markets.
- The lack of scale economies for the very small credit unions cannot be overcome by efficiencies at the corporate credit union level. The broader competitive financial market has simply made this impossible. Indeed, in concert with competition between the corporates, the subsidized support of the NPCUs for funding and services quite likely led to higher risk tolerance by the corporates to maintain earnings.
- A very compelling business case should be built for a holding company charter for credit unions to facilitate consolidation while preserving mission statements. This accommodation has helped the thrift industry achieve a more meaningful numbers/ economies of scale distribution, and needs serious and immediate consideration.
  - The above observation is acutely true if the Corporate Credit Union system is permanently and fatally impaired.
- The scale and efficiency of the corporate system needs to be evaluated. If the Corporate system is not financially competitive in the marketplace, it will ensure the demise of the industry that relies on it.
  - If a unique payment system nexus is required for the Credit Union industry this should be sought through special legislation and the corporate credit unions system privatized to provide added correspondent services to the industry on a competitive basis.

#### **Field of Membership Issues (National)**

If the corporate credit union continues to be a viable means by which services, investment and liquidity is provided to the NPCU's, then they should be able to compete on whatever scale their boards determine best meets the needs and convenience of the market. However, for the system to truly work on a competitive basis they need to be privatized and their equity traded to enforce market discipline. The preferred and notice type of capital now prevalent in the system precluded member NPCU's from exercising their discretion in the marketplace and minimizing their losses. The lack of transparency from US Central on down through the tiers of corporate credit unions, whose balance sheets were inextricably linked, led to larger losses than otherwise would have been possible under a competitive capital environment.

#### **Expanded Investment Authority**

The market for funds is large scale, national in scope and highly competitive with rating of the debt of market participants prevalent and necessary. While the ratings agencies have failed miserably in recent years, the corporates need to compete with very large competitors to raise funds cost effectively and manage their margins. The issue of expanded investment powers will not be answered in this debate, but

played out on a national scale with very difficult questions raised regarding, not just the investment vehicles in question, but also the efficacy of the underlying collateral and the national purpose served by alternative mortgage products. The corporates made the same mistakes as almost everyone else in the market due to imperfect ratings and a national collapse of the mortgage market. The broader question that only the Boards of the Corporates can answer is why these institutions felt compelled to pursue such high yield, high risk and high complexity investments when safer alternatives existed more consistent with the industry being served.

### **Structure Two-Tier System**

In retrospect, the system makes little sense but the observation is made with benefit of 20-20 hindsight. The ultimate damage done by highly interlocked balance sheets is now evident to all. The two-tier system failed because there was an inefficient governance structure, which precluded even invested retail corporates from understanding the investment problems at US Central. Their losses will now be born by the NPCU's having investments at the various second tier corporates nationwide; a national disgrace. Knowing the problem as we do now, there is little reason to argue for a two-tier system, it added only a level on opaqueness to an already difficult situation and maximized the effect on the balance sheets of an entire industry. Eliminate US Central, give payment powers to the retail-corporates and either privatize the corporates or organize them into the equivalent of the FHLB system.

### **Corporate Capital**

The corporates act like correspondent banks but specialize in services to the credit union industry. They are very large relative to the many credit unions that seek their services, so they are Core to the industry. If they are Core to the industry and operate like banks, then subject them to bank capital standards. The FHLB system electively follows the current bank capital standards and will adopt the Basel II standards when fully implemented in the U.S.. We should expect no less from the corporates, since it is evident that they are subject to the same systemic risks.

### **Permissible Investments**

There are no reasons to restrict investment powers of corporates; there are reasons to regulate them like the critical players they are. Enforcing good corporate governance, transparency and prudent management of investment, operational, liquidity and credit risk are all part of the same governance mandates. Bank-like, risk capital standards would make apparent the excessive credit risk appetite that was evidenced in the current collapse.

### **Credit Risk Management**

Suffice it to say, everyone missed the credit risk implications of the current market collapse, including the rating agencies. The question to focus upon, and it will undoubtedly be the root cause of problems within the corporate system, is what in the business model of US Central and several other corporates led to the acquisition of so much credit risk as a matter of on-going business. If the answer was serious pressure on earning to provide services to the industry, or core inefficiency in delivering these services, then the role of the corporate credit union system is seriously in question.

### **Asset and Liability Management**

Corporate credit unions are large organizations with billions at risk, there is little question that these institution should be required to perform the most sophisticated form of asset and liability management. The standards defined under the Basel II accord, with some modification, are quite warranted given the potential for cascading of financial problems throughout the industry. The NCUA should equip their field examiners with the knowledge and tools to provide the most sophisticated form of stress testing and

scenario analysis. Any and all measure that would provide further transparency into the operations of these operations are warranted if the industry is to remain shackled to their functions. It is apparent to our organization and many others that the inherent risk of the corporate credit union operations is intolerable and like many other NPCUs will be minimized going forward.

#### **Corporate Governance**

There should be one layer of corporate credit unions, the composition of that layer should be left up to the corporates to resolve, so as long as sustainable business operations and the preservation of member capital is the driving goal. The director structure should abide by all of the now prevailing standards of governance following Sarbanes-Oxley. There needs to be outside directors, directors should be compensated, they should be chosen on the basis of competencies needed on the board, the information flow from the organization should comport with the highest ethical standards of openness and transparency and terms should be limited with rigorous board self-evaluation conducted on a regular basis. The organizations should be run as businesses providing essential, cost-effective and non-subsidized services to NPCU's that are themselves properly governed and sustainable on a market basis.

In concluding, we thank the NCUA for the ability to comment on this very important credit union issue and look forward to their deliberative response to this industry crisis.

**Sincerely,**

Peter J. Muise  
President and CEO  
First Citizens' Federal Credit Union